1991 Federal budget

Background Paper

BP-251E

THE 1991 FEDERAL BUDGET

Marion G. Wrobel
Senior Analyst

February 1991

Library of
Parliament

Bibliothèque
du Parlement

Research
Branch

The Research Branch of the Library of Parliament works exclusively for Parliament, conducting research and providing information for Committees and Members of the Senate and the House of Commons. This service is extended without partisan bias in such forms as Reports, Background Papers and Issue Reviews. Research Officers in the Branch are also available for personal consultation in their respective fields of expertise.

Cat. No. YM32-2/251E

ISBN 0-660-14101-9

CE DOCUMENT EST AUSSI PUBLIÉ EN FRANÇAIS

CANADA

LIBRARY OF PARLIAMENT
BIBLIOTHÈQUE DU PARLEMENT

THE 1991 FEDERAL BUDGET

On 26 February 1991, the Hon. Michael H. Wilson tabled his seventh budget, his first in the midst of a recession. This budget was as notable for what it did not do as for what it did. Specifically, this was not a typical recession budget. Because of its belief that such policies do not work, the government did not propose short-term expansionary fiscal policy to try to stimulate the economy. The government argues that this rejection of "stimulative" spending is a necessity, in the sense that the deficit could not be allowed to balloon in the way it had done during the last recession. While today's deficit, expressed as a proportion of Gross Domestic Product (GDP), is no different from what it was at the start of the 1981-82 recession, the debt to GDP ratio, at just under 60%, is twice what it was then, at less than 30%. Because of this, the federal government now feels it has little room to manoeuvre in the face of a recession. In 1980-81, federal debt charges amounted to 17% of spending and 22% of revenues. Today, these charges amount to 28% of spending and 36% of revenues.

The purpose of this review is to highlight some of the major elements of this budget and to put them within the context of the fiscal framework that the government set out in 1984. This paper will also discuss those aspects of the budget that might be viewed as novel or innovative, compared with the kind of initiatives Canadians have seen in the past decade.

NEW FISCAL INITIATIVES

The major budgetary initiatives are on the expenditure side, as was the case in the 1990 budget. The only tax measures are a

substantial hike in the tax on tobacco and an increase in Unemployment Insurance (UI) premiums to keep that fund in balance.

Last year, the government presented a two-year expenditure plan intended to get the deficit back on a declining path and to allow more favourable economic conditions, such as lower interest rates, to speed up deficit reductions in the future. This two-year plan has now been extended for an additional three years. Over the full five-year life of this expenditure control plan, total savings are expected to amount to $14,819 million, in addition to the $6,000 million savings due to the initial two-year reduction plan announced in the 1990 budget.

The largest expenditure reductions will arise from the five-year expenditure freeze placed on certain programs, with much the greatest savings coming from the freezing of per capita Established Programs Financing (EPF) transfers to the provinces. This measure alone will save the federal government $2,340 million over the five years, in addition to the $2,410 million savings announced last year. In the future, when the normal growth provisions (i.e. the rate of growth of GNP minus three percentage points) are re-established, they will be applied to a lower base. Consequently, savings will extend beyond the five years of the freeze. Other programs are also subject to a total five-year spending freeze but the savings from these pale in comparison to the savings associated with EPF.

A second set of programs was subject last year to a 5% per annum growth for a two-year period. They will now be subject to a 3% maximum growth rate for a further three years, once the 5% limit has expired. These programs include science and technology funding, and development spending. Canada Assistance Plan (CAP) payments to the richer provinces will grow by no more than 5% per year for a total of five years. Green Plan spending will be spread over six years rather than five.

Other programs are being cut. Grants and contributions should be reduced by over $500 million over five years. Reduced spending on social housing will save an additional $400 million and the Canadian Jobs Strategy is to be cut by $100 million next year.

Finally, there are a number of management initiatives designed to increase efficiency and reduce operational expenditures. The reduction in public sector operating budgets as a result of these new initiatives should trim $3,600 million over five years.

Wage Restraint: The government is proposing that across-the-board wage and salary increases in the public service be no higher than 3% per annum for the next three years. This is to apply to wage contracts negotiated through the bargaining process as well as third-party awards granted by arbitrators.

Wage restraint goes beyond this 3% across-the-board cap, however. For the year 1991-92, the government will not "...increase operating budgets to compensate for wage and salary increases." This does not mean that budgets will be frozen at their 1990-91 levels; rather it means that any unanticipated increases to the wage bill will not be accommodated. For the next two years, operating budgets will increase by no more than 3% per year to accommodate increased salaries. The operating budget cap implies a manpower reduction of 6,000 persons in the first year of the program, if wages exceed the budgeted amount by 3%.

These provisions constitute constraints to the total wage bill. Promotions, increased overtime, etc. will also have to be financed out of constrained budgets. It is possible, then, that across-the-board settlements will have to be below 3% to prevent reductions in employment levels. Moreover, grade inflation will not be able to be used to circumvent the 3% wage and salary guidelines. This restraint package represents a binding constraint on wages and salaries.

Program Spending Restraint: The federal government is proposing to table legislation which would limit cumulative program spending from 1991-92 to 1995-96 to $615,300 million. This legislation would also set limits for each year, with program spending growing by an annual average of 3.05%. Some flexibility in annual program spending is to be allowed but any excess in one year would have to be offset in another. Exceptions to these limits include programs that are self financing, such as unemployment insurance, as well as expenditures related to unpredictable events such as wars or

natural disasters. This legislation will override other legislation and the spending limits could be exceeded only by authority of another Act of Parliament.

Debt Servicing and Reduction Fund: Federal revenues normally go into the Consolidated Revenue Fund, a pool from which expenditures are financed. The budget proposes creation of a new Debt Servicing and Reduction Fund into which would flow all GST and privatization revenues as well as any donations to the government for debt reduction. To the extent financially possible, this fund will finance debt service charges and debt reduction.

The existence of this new fund is neither necessary nor sufficient for future deficit reductions. Higher-than-anticipated GST revenues could always be used to reduce the deficit. Doing so through the mechanism of this fund will not constrain the government from using this opportunity to reduce other taxes, nor does it constrain the government from increasing program spending. Such controls come about as a result of the legislated limits on spending.

The annual deficit is the difference between total spending and total revenues. It will not matter that GST revenues go to paying debt charges or paying off the debt; if they did not, some other taxes would pay for those costs. And because GST revenues are to be used exclusively for paying interest costs, they will no longer be available to finance existing programs.

TRANSFERRING THE DEFICIT TO THE PROVINCES

Like the 1990 budget, this budget is being criticized in provincial circles as simply transferring the federal fiscal problem to the provinces. The fact that federal taxes remain largely unchanged will be little consolation to taxpayers if provincial taxes are forced higher.

By cutting CAP and EPF transfers to the provinces, the federal government is attempting to achieve several goals. Its own attempts to tighten fiscal policy through spending restraint are hindered by the high level of debt and debt servicing charges it faces. On average

the provinces pay only one-third as much in debt servicing costs as does the federal government, which is thus now attempting to pass on some of this burden to the provinces.

Secondly, the federal government is trying to get more of its own program spending under control. This is not always easy. For example, the CAP program is driven by the provinces. As long as they meet certain criteria, the federal government must contribute one dollar for every dollar the provinces spend in this area. In this sense, federal spending is not under the control of the federal government.

EPF funding is designed to help finance a variety of programs delivered by provincial governments. In the past these transfers were directly related to health and post-secondary education; they are now delivered as block grants, totally unrelated to actual provincial spending. The federal government justification for limiting these transfers to the provinces is the fact that provincial spending growth has far outpaced federal spending growth since 1985. Despite the freeze, the Minister predicts that transfers to the provinces will still grow faster than federal program spending.

This extended freeze in per capita EPF transfers poses a problem for the federal government. It is possible that, because of the freeze, some provinces will no longer receive cash transfers by 1996. Should this be the case, the federal government could no longer enforce the provisions of the existing *Canada Health Act* by threatening to withhold EPF cash transfers. Consequently, the Minister has announced that the federal government will be tabling amendments to that Act in order to preserve federal enforcement power.

FISCAL POLICY SINCE 1984

Soon after the Conservatives took power in September 1984, Mr. Wilson presented an economic statement in the House of Commons, in which he warned Canadians that the existing fiscal policy was on a dangerous path, and that by 1990-91 the net debt would reach more than 60%

of Gross Domestic Product (GDP), a 50% increase, while the dollar value of the net debt would double to over $400 billion.

In 1984, the federal government predicted continually declining deficits to the year 1990-91, from 8% of GDP to 5.8%. All of this deficit decline was due to expenditure reductions since, in the absence of any revenue initiatives, the Department was predicting flat revenue growth. Since 1984, a number of measures have been introduced by the government to speed up deficit reduction; these have been successful in the sense that the deficit is less than was originally predicted. But if we compare the actual deficit with the status quo projections of the government in 1984, we must attribute the success to greater revenues than were originally anticipated. These projections can be observed in the two attached charts, which compare status quo projections (labelled sq) with the actual trends as forecast in the recent budget (labelled 91). (Note that the status quo projections do not extend beyond fiscal year 1990-91.)

Federal spending has almost consistently exceeded 1984 projections. Interest charges have been far higher than were originally projected, more than offsetting any declines in program spending. Even program spending, however, has only recently fallen below the status quo projections of 1984 while the poor economic conditions of 1990 and 1991 have temporarily reversed this trend.

It is clear that the federal government has had some success in reducing the deficit and debt problem that it predicted (and in fact underestimated) in 1984. Rapid economic growth since then has not had much effect in speeding up this process. The stumbling block has been the level of interest rates in Canada; the Minister had underestimated interest rates in the 1980s, predicting an average real rate of 2.7% for the last half of the decade. Likewise, the future deficit path is heavily dependent upon the accuracy of his interest rate forecasts for the next few years. The onset of the present recession, represents a new hurdle for the deficit and debt projections of the Minister of Finance.

THE IMPACT OF THE RECESSION

Because of the recession, cumulative additions to the net debt are going to be about $5,700 million higher over a two year period than was forecast last year. The 1990-91 deficit will be $30,500 million rather than $28,500 million and the 1991-92 deficit will remain at that level, rather than declining to $26,800 million.

If these increased deficit projections prove accurate, they will still be a remarkable testament to the government's commitment to deficit reduction, and will be in sharp contrast to financial developments in the last recession when the deficit increased by over $14,000 million in one year.

It is somewhat surprising that personal income tax revenues are higher than originally forecast in 1990, despite the recession. Negative fiscal developments, though, are the sharp increase in UI benefits, the substantial reduction in corporate income taxes and the repeated underestimation of debt servicing costs. And although the federal government has relied heavily on controlling program spending, progress there is being temporarily sidetracked as a result of the recession and other unforeseen developments such as the war in the Gulf.

CONCLUDING COMMENTS

This budget puts much effort in signalling to Canadians that the federal government's fiscal policy will continue to be conducted with one general goal in mind; namely, to reduce the rate of growth of the public debt and eventually to reduce the debt-to-GDP ratio. The federal government sees high interest rates as the major stumbling block to continued adequate economic performance. Such high interest rates are linked to an imprudent and untenable debt situation, as well as to monetary instability.

The first important signal is the promise to legislate program spending limits. While such legislation can obviously be overridden by future Parliaments, and indeed by this government itself,

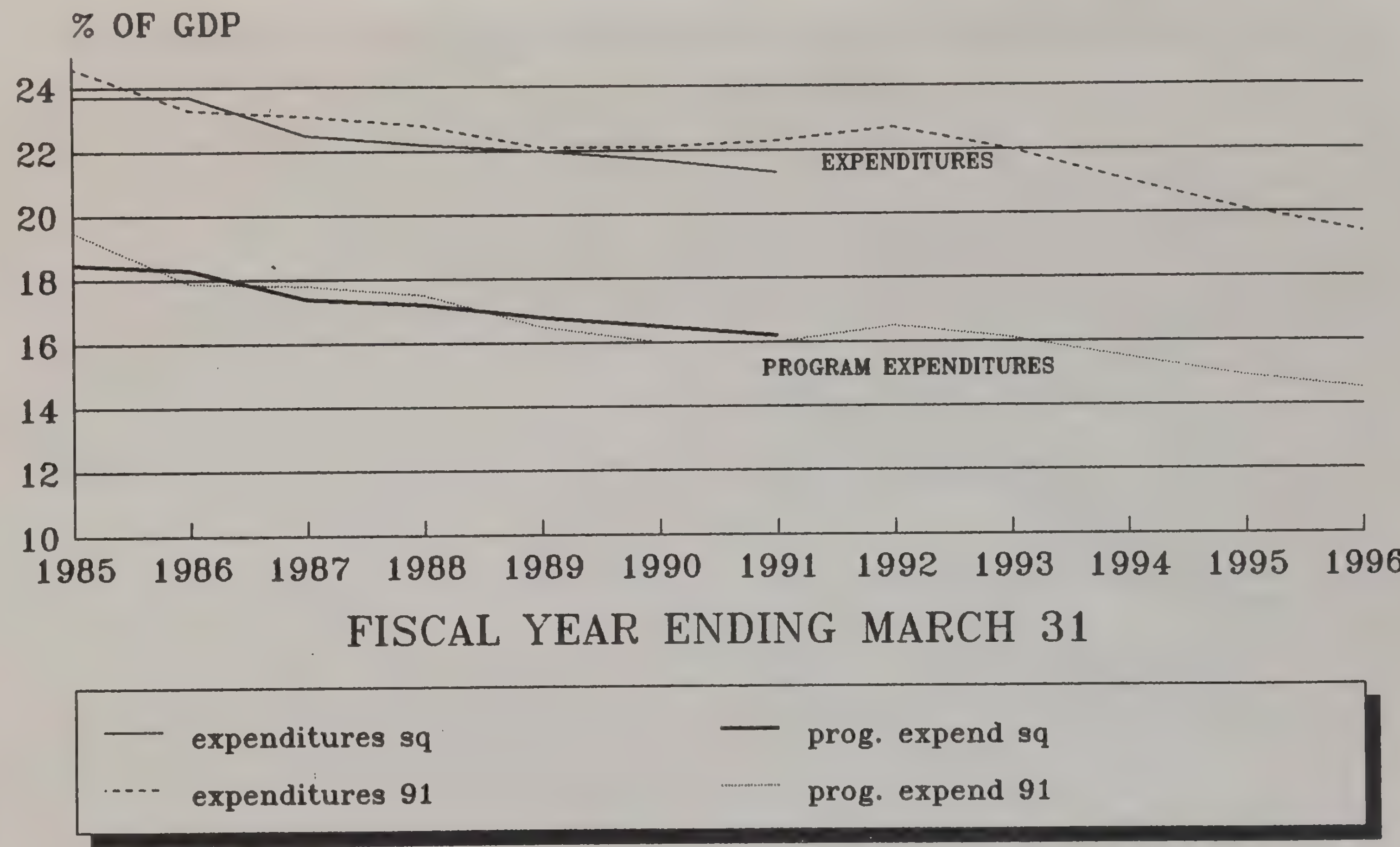
such a policy option would require an explicit repudiation of current fiscal policy.

A second signal is the establishment of the debt servicing fund. In practical terms it is of little value by itself since the deficit and debt could be increased despite the existence of this fund. The fund and the legislated spending levels will make it awkward for the government to increase program spending in the future, even if the GST proves to be a more efficient revenue source than was foreseen.

The third important signal is the establishment of future inflation targets. Until now, many have felt that the task of fighting inflation had been left solely to the Bank of Canada, requiring it to impose especially tight monetary policy in the face of increased inflationary pressures. Monetary policy cannot be very credible if it is inconsistent with fiscal policy. This budget represents an explicit commitment on the part of fiscal authorities to be aware of, and in control of, the inflationary consequences of their actions. Co-ordinating monetary and fiscal policies should reduce the costs of anti-inflationary policy.

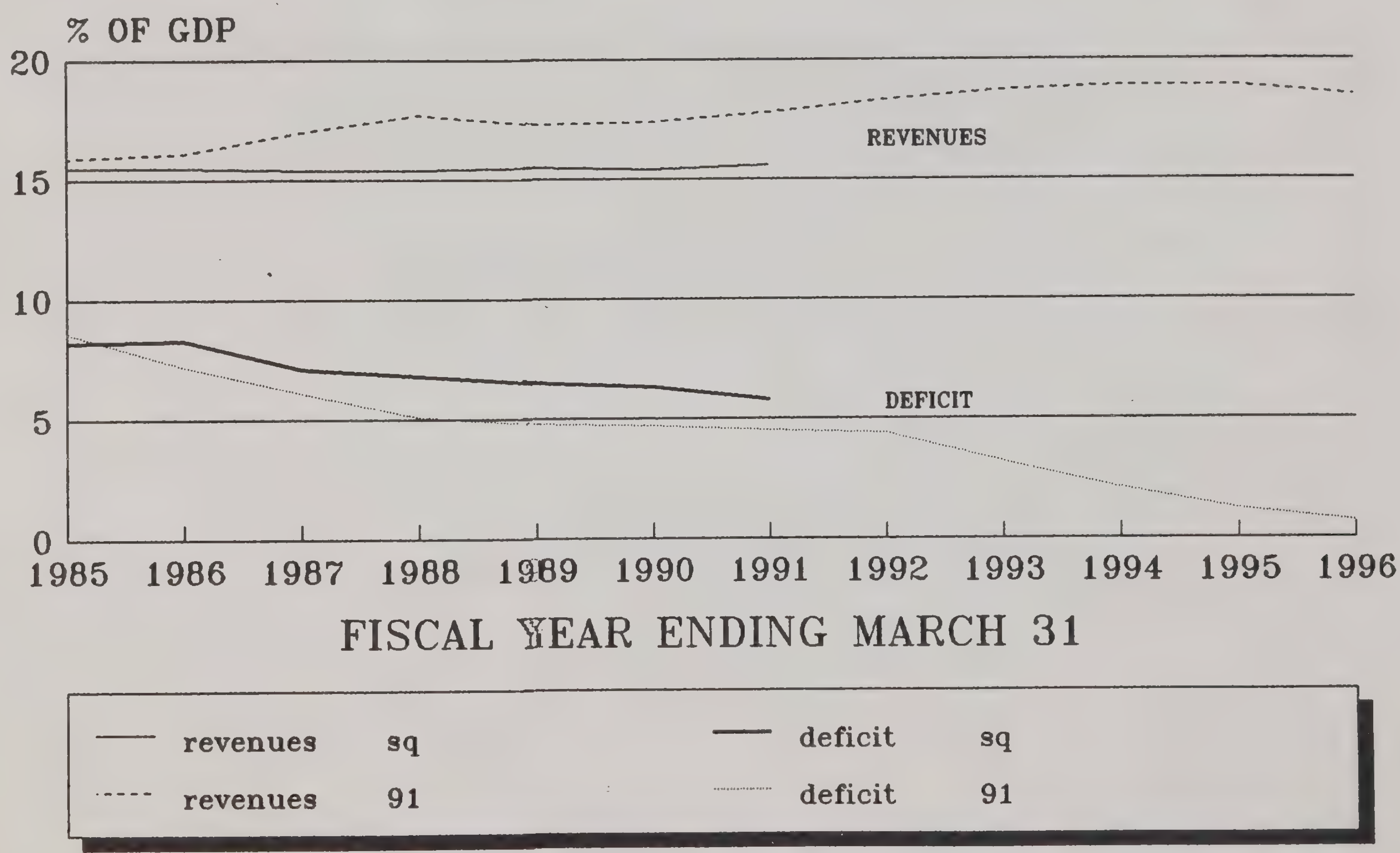
The final, and probably most important, signal is the fact that the government has not let the deficit increase substantially in the face of the current recession. If the government can persuasively argue that tight fiscal policy is appropriate now, it would be hard pressed to justify lax fiscal policy in the coming recovery, particularly in light of the inflation targets it is now setting. Moreover, the government has identified high interest rates as responsible for poor economic performance and has attributed a large part of the culpability for these high rates to the public debt. Policies which would increase the debt would, therefore, be counterproductive.

FEDERAL SPENDING
1984 STATUS QUO VS BUDGETARY MEASURES



1984 ECONOMIC STATEMENT, 1991 BUDGET

FEDERAL REVENUES AND DEFICIT
1984 STATUS QUO VS BUDGETARY MEASURES



1984 ECONOMIC STATEMENT, 1991 BUDGET